STATE OF IOWA

DEPARTMENT OF COMMERCE

UTILITIES BOARD

IN RE: INTERSTATE POWER COMPANY and IES UTILITIES INC.	DOCKET NOS. ARC-01-150 ARC-01-151

ORDER

(Issued April 8, 2002)

INTRODUCTION AND PROCEDURAL HISTORY

Iowa Code § 476.6(16) requires that the Utilities Board (Board) "shall periodically conduct a proceeding for the purpose of evaluating the reasonableness and prudence of a rate-regulated public utility's procurement and contracting practices related to the acquisition of fuel for use in generating electricity." The statute further provides that the proceeding is to be conducted as a contested case proceeding pursuant to Iowa Code chapter 17A and that the Board may also review the utility's compliance with the federal Clean Air Act. Subrule 199 IAC 20.13(1) provides that the Board is to notify a utility by January 31 if a fuel procurement plan is required for that year. The utility must then file its plan by May 31. The rule provides that the plan must include the following information:

1. Purchase contracts and arrangements for fuel and transport.

2. Contracts and arrangements for purchasing and selling Clean Air Act allowances.

3. Purchase power contracts or arrangements, including sale of capacity contracts, involving over 25 MW of capacity.

4. Pool interchange agreements.

5. Multi-utility transmission line interchange agreements.

6. Interchange agreements between investor-owned utilities, generation, and transmission cooperatives, or both.

Subrule 199 IAC 20.13(1) further requires 12-month projections for fuel and transport contracts and a list of fuel and transport contracts that expire within the next five years. In addition, the utility must provide a list of all contracts in items 1 through 6 that have been offered to the utility since its last ARC filing.

On January 19, 2001, the Board ordered Interstate Power Company (Interstate) and IES Utilities Inc. (IES) n/k/a Interstate Power and Light Company to file a joint fuel procurement plan on or before May 15, 2001. Interstate and IES are the two public utility affiliates of Alliant Energy (Alliant) providing retail electric service to Iowa customers. Alliant has another public utility affiliate, Wisconsin Power and Light, which provides retail electric service to Wisconsin customers. The Board's January 19, 2001, order also required that Interstate and IES file additional information regarding purchase power contracts, including how Alliant intended to replace supply from expiring contracts.

The Board's decision to conduct an ARC proceeding was prompted, in part, because several of Interstate's long-term supply contracts were set to expire in April 2001. It appeared that both IES and Interstate were increasingly relying on short-term power markets, as opposed to long-term contracts, and that this was reflected in increases in costs passed through each utility's energy adjustment clause (EAC). IES in particular projected significant increases in EAC costs.

On February 23, 2001, the Board ordered that further additional information be included in the ARC filings. The Board also directed its staff to conduct an EAC audit, which was completed and submitted to the Board on May 14, 2001. The audit was later filed by IES and Interstate as part of their rebuttal testimony in this proceeding as Exhibit 4, Schedule H.

Interstate and IES filed their joint procurement plan on May 15, 2001. In addition to the Consumer Advocate Division of the Department of Justice (Consumer Advocate), the Large Energy Group Intervention Alliance (LEGIA), the Iowa Consumers Coalition (ICC), and MidAmerican Energy Company (MidAmerican) intervened in the proceeding. All intervenors except MidAmerican submitted prefiled testimony and participated at the hearing. The LEGIA consists of 16 large industrial customers of Interstate and IES. The ICC is a coalition consisting solely of large customers of IES.

The Board docketed the ARC filing and established a procedural schedule by order issued June 19, 2001. Both in this order and the January 19, 2001, order, the Board put IES and Interstate on notice that the ARC proceeding would address three additional issues that would be consolidated with the traditional ARC fuel procurement and contracting issues because much of the testimony of fuel procurement and contracting also related to these three issues. The issues are:
1) Whether Alliant's contracting practices have resulted in violation of the rate freeze

agreed to by IES and Interstate in the merger with Wisconsin Power and Light to form Alliant, 2) whether the current energy adjustment clause flow-through should be replaced with incentives to reduce fuel costs similar to those that MidAmerican is operating under pursuant to a contested case settlement, and 3) whether an adjustment should be made to reflect capacity costs for long-term contracts that will soon be expiring, if those long-term contracts are not replaced.

A hearing was held beginning on November 6, 2001. IES and Interstate submitted late-filed exhibits on November 19, 2001, in response to information requested by the Board at hearing. All parties except MidAmerican submitted initial and reply briefs.

DISCUSSION

The Board will examine several issues individually. In examining these issues, the Board is mindful of the fact that the ARC proceeding is defined by Iowa Code § 476.6(16) to be an evaluation of the "reasonableness and prudence of a rate-regulated public utility's procurement and contracting practices related to the acquisition of fuel for use in generating electricity." The Board with this ARC proceeding also consolidated three other issues. As the Board examines these issues, it is apparent that if relief is warranted, it is more appropriate in a rate proceeding because some of the costs at issue are not yet included in Interstate's or IES' rates.

In addition, the Board emphasizes that the failure to disallow increased fuel costs in this proceeding does not mean Interstate and IES have met their burden of proof that their plan is reasonable and prudent. Rather, it simply means that the record in this proceeding does not contain sufficient evidence to warrant a disallowance of fuel costs. Such evidence might later be presented in another proceeding.

Energy Adjustment Clause and Rate Freeze

Interstate and IES both utilize an energy adjustment clause (EAC), which allows monthly fuel costs to flow automatically to ratepayers. The energy adjustment clause fluctuates on a monthly basis as fuel costs change. Only energy charges flow through the EAC; capacity charges have traditionally been recovered in base rates.

In its January 19 and June 19, 2001, orders, the Board expanded the traditional ARC proceeding to three issues specifically related to the EAC. In all of these issues, the focus is on whether the EAC, in the current energy environment, gives the appropriate incentives to minimize fuel costs, or whether the current EAC rules as they apply to IES and Interstate need to be modified or eliminated. The other investor-owned electric utility providing retail electric service in Iowa, MidAmerican Energy Company, does not currently use an EAC. MidAmerican's EAC was eliminated pursuant to a settlement approved by the Board. In simple terms, the settlement sets a base line for fuel costs in tariffed rates. If MidAmerican spends less on fuel than the amount included in base rates, MidAmerican retains the excess. If MidAmerican spends more on fuel, MidAmerican shoulders the risk and shareholders are ultimately responsible for the amount. There is a process for readjustment of the base line if circumstances warrant.

The first EAC issue is whether Alliant's contracting practices have resulted in a violation of the rate freeze agreed to by IES and Interstate in the merger with Wisconsin Power and Light to form Alliant. This is related to a second EAC issue, whether an adjustment should be made to reflect capacity costs for long-term contracts that will soon be expiring, if those long-term contracts are not replaced.

As part of the merger, IES and Interstate agreed to a rate freeze that ends in April 2002. The rate freeze by its terms applied to base rates and did not apply to the utility's respective EACs, which would presumably continue to fluctuate on a monthly basis. Because the rate freeze did not specifically apply to EAC charges, a regulatory incentive was created for IES and Interstate to transfer demand costs into energy costs because energy costs would not be subject to the rate freeze. In addition, certain expiring long-term contracts, which had their costs divided between demand and energy costs, were not replaced with other long-term contracts. The capacity or demand costs associated with those contracts remain in base rates until the next general rate proceeding. If those contracts are replaced with short-term contracts consisting largely or wholly of higher energy charges, the higher energy charges are recovered through the EAC, in spite of the rate freeze, while capacity charges that no longer exist continue to be recovered through base rates.

There is no question that Alliant has generally replaced expiring long-term contracts with contracts for short-term gas fired generation, which reduces its demand charges and increases its energy charges from previous levels. This result is the basis for Consumer Advocate's recommendations for refunds and reductions in base rates. However, it appears Alliant's strategy is based on its 15-year resource plan and the record does not contain any evidence of specific errors in the resource plan or purposeful manipulation of the split between contract demand and energy costs. In fact, with the Reliant contract, Alliant incurred higher demand charges in order to secure lower energy costs. (Tr. 209-11; 310-13). Also, while demand charges for IES have decreased, such charges have increased for Interstate during the 1997-2000 period examined by the Board. (Ex. 101, Sch. A). There is insufficient evidence to suggest that Alliant violated its rate freeze or engaged in any manipulation of demand and energy charges.

The Board notes that Consumer Advocate's proposal also raises difficult legal issues involving single-issue ratemaking and the filed rate doctrine, which need not be addressed here because the Board is not ordering a reduction in base rates. While the Board is troubled by the decrease in IES' demand costs without a corresponding reduction in rates, this decrease is more than offset by the increase in Interstate's demand costs. This offset is powerful evidence that no manipulation occurred and points out the difficulty in singling out one cost for an adjustment outside a full rate proceeding.

Other intervenors were troubled by Alliant's failure to use an RFP process for its short-term contracts, which Alliant has defined as contracts of three years or less. As will be discussed under long-term system planning later in this order, the Board's rules do not mandate an RFP process and there is no evidence that an RFP process would have resulted in lower prices. Alliant contended the short-term market is much more transparent than the long-term market. However, there is a lack of documentation both with respect to the process used by Alliant to reach its decision and the actual information relied on in the decision-making process.

The final EAC issue is whether the current EAC should be modified. As noted earlier, the EAC, in its current form, does provide regulatory incentive to reduce demand charges and increase energy charges. This is particularly true between test years or when a rate freeze or rate cap in some form is in place.

The ICC recommends requiring Alliant to file one or more alternative cost recovery mechanisms to replace the EAC in Alliant's next rate case, and LEGIA favors eliminating Alliant's EAC altogether. Eliminating the EAC may be too harsh a remedy, especially when there is no clear evidence of undue manipulation or imprudence by Alliant. Nonetheless, the Board is concerned about the wide fluctuations in Alliant's EAC energy costs over the last two years, with costs nearly doubling during the first half of 2001 alone. Considering this volatility, and the power market changes described by Alliant (Tr. 180-82), the current EAC mechanism may be outdated and inappropriately matched to the utility's power purchase practices and costs.

The Board prefers ICC's approach and encourages Alliant to address the issue of EAC alternatives in its next rate case. If the issue is not addressed in the rate case, the Board intends to commence a rule making to address changes to the current EAC. Among the range of possible alternatives, the Board might consider capping or otherwise redesigning the EAC in some manner. The current EAC must be modified or eliminated if it is not providing appropriate regulatory incentives in today's market.

Long-Term System Planning

IES and Interstate emphasized throughout these proceedings that Alliant Energy Corporate Services (AECS), an Alliant subsidiary that acts as the agent for the Alliant operating companies, including IES, Interstate, and Wisconsin Power and Light, does the planning for all three operating companies on a single-system wide basis. AECS utilizes resource planning that is driven to find the lowest total costs of capacity and energy. Resources are also dispatched on a system-wide basis.

The Board's concerns with Alliant's planning and dispatch methods are that while the planning and dispatch are done on a system-wide basis, there are so many constraints on the transmission system that this "virtual" planning and dispatch cannot be functionalized. For example, the audit report shows that transmission capacity between the Alliant-West (Iowa) and Alliant-East (Wisconsin) control areas is 150 MW. Energy flowing between the two control areas within the 150 MW limit use the transmission facilities of Alliant-West and the American Transmission Company, which controls Alliant-East's transmission assets. If the energy flow exceeds 150 MW, another transmission owner's facilities must be used. This increases the number of transmission charges Iowa customers must pay for energy that flows from Alliant-East to Alliant-West.

Alliant's recent resource acquisitions, including the Rockgen and Rivergen contracts, which will be discussed in greater detail below, appear to be primarily driven by requirements of the Wisconsin Public Service Commission (Wisconsin PSC). While the Board cannot point to a specific planning or dispatch decision that has been imprudent, the overall conclusion from the testimony is that Wisconsin has been the primary driver of the planning process.

This tenor is unacceptable to the Board. Two-thirds of Alliant's electric utility operations are in Iowa, and the Board believes the interests of Iowa customers must be given greater emphasis in the planning and dispatch process. The Board is encouraged by Alliant's recent behavior, including the opening of an expanded Des Moines office and announced plans to build generation in Iowa, and will monitor Alliant's actions to make sure that a strong commitment to its Iowa customer base is maintained. The Board will not hesitate to disallow in a rate proceeding contracts or other expenses where actual benefits to Iowa customers cannot be established. "Virtual" benefits will not be sufficient.

Another option available to the Board if Alliant's long-term system planning remains unacceptable is through management efficiency. Pursuant to Iowa Code § 476.52, in the course of a proceeding conducted under Iowa Code §§ 476.3 or 476.6, if the Board determines a utility is operating in an inefficient manner or is not exercising ordinary, prudent management, the Board may reduce the level of profit or revenue requirement to provide incentives to the utility to correct its behavior.

Because of Alliant's pending rate case, the Board will not directly address management efficiency in this proceeding.

The Board wants to emphasize to IES and Interstate that it does not intend to be a "Monday morning quarterback" with respect to its planning and procurement decisions. Any decision can be second-guessed with the benefit of hindsight. What the Board intends to examine in future proceedings is whether the utility acted prudently based upon the information that was available at the time the decisions were made. In addition, the Board will examine whether the decision-making process obtained the appropriate information for making the decision, and whether the results of the process were documented.

Rockgen, Rivergen, and Reliant Contracts

There are three contracts at issue that underscore the Board's belief that Alliant's planning process did not adequately consider the interests of Iowa's ratepayers. The first is the Rockgen contract.

Rockgen is located 15 miles east of Madison, Wisconsin, and houses three 150 MW combustion turbine generation units. The facility began operation in May 2001 and is owned by a subsidiary of Calpine Corporation. The Alliant Energy operating Companies (IES, Interstate, and Wisconsin Power and Light) own the capacity rights at Rockgen for a period of years while Duke Energy Trading and Marketing (DETM) owns the energy pricing rights. However, Alliant has the right of first refusal to the energy in a contract with DETM at a rate that could be significantly higher than the rate DETM pays for the energy. Wisconsin Power and Light facilitated the siting, development, and construction of Rockgen through a 1997 request for proposals (RFP) process.

The Wisconsin PSC, in an order issued June 19, 2001, found that Wisconsin Power and Light was imprudent when it entered into the Rockgen and DETM contracts because there were duplicative costs and denied full rate recovery of the capacity costs. The ICC and LEGIA urge the Board to follow Wisconsin and deny recovery of some of the capacity costs to ensure that Iowa ratepayers do not pay charges for a facility that Wisconsin consumers do not have to pay. The intervenors are also concerned that the contract's terms pose significant risks of uncontrolled energy costs during peak conditions. (Tr. 571-72; 596-97).

The RFP for Rockgen was sent out exclusively by Wisconsin Power and Light in response to a Wisconsin PSC order requesting bids for 150 MW to be built in Wisconsin. Alliant later determined to expand the contract to 450 MW, although the basis for this decision is not clear from the testimony. Alliant claims the contract also benefits Iowa and some of the capacity is assigned to its two Iowa utilities. However, because there is no firm transmission path to Iowa from Rockgen, it is likely that there will be problems in getting energy from Rockgen to Iowa during peak periods and peak power for the Iowa utilities will have to come from other sources. The Board is convinced from the record that the contract was signed primarily to benefit Wisconsin Power and Light and that claimed benefits to Iowa consumers are more of an after-the-fact rationalization.

However, it is not appropriate to disallow any Rockgen capacity costs in this proceeding, because none of those costs are currently reflected in rates. A disallowance is only appropriate in a rate proceeding if IES or Interstate proposes to include some or all of these capacity charges in their base rates. With respect to the energy charges, the contract is structured in such a way that significant risks do not appear for Interstate until this year and have not materialized to date. For IES, the risks increase in 2003. Therefore, the Board will not disallow any energy costs at this time but will require IES and Interstate to provide information in their monthly EAC filings like that provided in Exhibit 3, Schedule J, page 1 of 1, for any month where IES, Interstate, or Wisconsin Power and Light purchase from Rockgen. This way, the Board can compare the costs paid by each of the three Alliant operating electric utilities and take appropriate action if excessive costs are flowing to Iowa ratepayers.

The second contract discussed is the Rivergen contract. Again, this is a contract entered into by Wisconsin Power and Light on behalf of the other Alliant operating companies. This is a 600 MW combined cycle generating facility built by SkyGen Energy L.L.C. that is expected to be operational in June 2003. The facility is located next to an existing Wisconsin Power and Light facility. AECS is facilitating the siting, development, and construction of the facility through an RFP process conducted in May 2000.

Because the facility will not be operational until 2003 and is not currently scheduled to provide capacity to Interstate or IES, it need not be addressed further in this proceeding. However, if the Iowa utilities receive energy from the facility, the

Board may require a monthly EAC filing similar to that for the Rockgen facility. While Alliant indicates the contract is one of the asset-backed resources formally solicited for the benefit of Alliant ratepayers, the RFP only mentions the needs of its Wisconsin utility. This appears to be another example where the claimed benefits to Iowa ratepayers appear to be simply an after-the-fact rationalization for a process that was clearly driven by needs of the Wisconsin utility and requirements of the Wisconsin PSC.

The third and final contract to be discussed is the Reliant Contract. The contract is for 100 MW and is between IES and Reliant Energy Services (Reliant). As noted by the intervenors, no formal RFP process was used. Reliant was a noncompliant bidder in the Wisconsin-focused process that resulted in the Rivergen contract. Reliant's proposal was disqualified, because the generation was not located in Wisconsin.

After reviewing the terms of the contract, the Board does not find adequate evidence to support a disallowance. The terms of the contract are certainly more favorable than the Rockgen contract. However, the Board is concerned that the process resulting in this contract was flawed. The appearance is that Iowa ratepayers got the "leftovers" from a Wisconsin RFP driven by the needs of Wisconsin Power and Light and the requirements of the Wisconsin commission, and that no further investigation into current contract prices was documented by Alliant personnel. While competitive bidding is not mandated, the Board is concerned that there is no significant documentation of the process and investigation that resulted in this contract. The Board expects better processes to be used in the future.

Sixth Street Station

Concerns were raised by the LEGIA that IES' Sixth Street Station, an electric generating unit, is not being economically dispatched. While the Board is not persuaded that the units are being dispatched uneconomically, a legitimate question has been raised about cost allocation. The Sixth Street Station is used not only to generate electricity but for steam sales. The Board does not regulate steam sales.

The LEGIA recommends a disallowance of some generation costs associated with Sixth Street Station. The LEGIA's argument is based largely on an alleged misallocation of costs between electric and steam production. The formula used for the allocation of costs between steam and electricity production is a base rate allocation issue that can be examined in IES' next rate case. The Board can determine whether the running of the Sixth Street Station is driven primarily by steam sales or electric sales and make any necessary adjustments in the cost allocations. Obviously, if all the costs associated with steam production are not properly allocated to steam sales, electric customers are paying costs that are not associated with the production of electricity and the allocations must be changed. In addition to examining this issue in a rate case filing, the Board will order IES to format Sixth Street Station fuel costs similar to the format currently used for Red Cedar Station so the costs can be closely tracked. Finally, IES will be ordered to provide monthly information on steam revenues and associated costs relevant to Sixth Street Station steam production.

Price-Risk Management Programs

IES and Interstate receive approximately one-third of the natural gas burned in their generating units from Alliant's local distribution company. The ICC argued that IES and Interstate have not been prudent in procuring natural gas for their electric generating facilities, particularly because the utilities had not adopted any price risk management strategies.

This issue has receded from the forefront because natural gas prices have stabilized as compared to a year ago, when prices were extremely high and volatile. However, because prices have stabilized, at least for the time being, this provides an opportunity for IES and Interstate to evaluate various price-risk management tools that are available. Based on recent experience, the only thing predictable out of energy markets is their unpredictability. While the evidence in this proceeding does not support a finding of imprudence in natural gas procurement for electric generation, IES and Interstate are encouraged to collaborate with interested parties in a detailed examination and evaluation of price-risk management tools that would protect customers from the extreme volatility that was experienced during the winter of 2000-2001. IES and Interstate have only recently begun to explore such strategies, and a collaborative process should provide additional input from the customer's viewpoint.

The Board recognizes that there is a cost to using risk-management tools. The protection these tools provide from volatile markets, though, may be well worth the costs, even if it is determined after-the-fact that risk-management tools were not necessary for a particular year or season. The Board once again emphasizes its position that utilities will not be faulted if their actions are prudent based upon the information that was available at the time procurement decisions are made.

Currently, the EAC does not allow the pass-through of the costs of price-risk management programs. Costs of such programs for rate-regulated utilities providing retail natural gas service are recoverable through the purchased gas adjustment clause. The collaborative process should explore and, if possible, make recommendations on the issue of cost recovery. Among the alternatives are waiver or modification of current EAC rules.

FINDINGS OF FACT

1. While the Board has concerns about, among other things, deficiencies in Alliant's planning process and documentation, it is reasonable to conclude that IES and Interstate have not undertaken actions in violation of the rate freeze agreed to in the merger of IES, Interstate, and Wisconsin Power and Light to form Alliant Energy.

2. While the Board has concerns about, among other things, deficiencies in Alliant's planning process and documentation, it is not reasonable to change IES' and Interstate's base rates in this proceeding to reflect the cessation of demand charges associated with expiring long-term electric supply contracts.

3. While the Board has concerns about, among other things, deficiencies in Alliant's planning process and documentation, there is insufficient evidence to eliminate or modify IES' and Interstate's energy adjustment clause in this proceeding, but the issue warrants further investigation in a rate case or other appropriate proceeding.

4. While the Board has concerns about, among other things, deficiencies in Alliant's planning process and documentation, it is not reasonable, based on the record in this proceeding, to disallow any fuel costs in this proceeding.

CONCLUSIONS OF LAW

The Board has jurisdiction of the parties and the subject matter in this proceeding, pursuant to Iowa Code chapter 476 (2001).

ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. IES Utilities Inc. and Interstate Power Company n/k/a Interstate Power and Light Company shall file the information discussed in the body of this order with their respective monthly energy adjustment clause filings.

2. Motions and objections not previously granted or sustained are denied or overruled. Any argument in the briefs not specifically addressed in this order is rejected either as not supported by the evidence or as not being of sufficient persuasiveness to warrant comments.

UTILITIES BOARD

/s/ Diane Munns

/s/ Mark O. Lambert

ATTEST:

/s/ Judi K. Cooper
Executive Secretary

/s/ Elliott Smith

Dated at Des Moines, Iowa, this 8th day of April, 2002.